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FM AMEMBASSY WELLINGTON
TO RUEHC/SECSTATE WASHDC 5337
INFO RUEHNZ/AMCONSUL AUCKLAND 1708
RUEHBY/AMEMBASSY CANBERRA 5220
RUEHDN/AMCONSUL SYDNEY 0699
RHHMUNA/CDR USPACOM HONOLULU HI
RUEHZU/ASIAN PACIFIC ECONOMIC COOPERATION
RUEHSS/OECD POSTS COLLECTIVE
RUCPDOG/USDOC WASHDC 0242
RUEATRS/DEPT OF TREASURY WASHDC
RUEHRC/DEPT OF AGRICULTURE WASHDC
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SENSITIVE
SIPDIS

STATE FOR EAP/ANP, EB, INR, STATE PASS TO USTR, PACOM FOR
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TAGS: [ECON](#) [EFIN](#) [ETRD](#) [PGOV](#) [PREL](#) [NZ](#)

SUBJECT: RESERVE BANK OF NEW ZEALAND SEES RECESSION AS A MORE
IMMEDIATE THREAT TO NEW ZEALAND ECONOMY THAN INFLATION.

REF: WELLINGTON 225

11. The Reserve Bank of New Zealand (RBNZ) announced today that it is cutting the Official Cash Rate (OCR) by 25 basis points. Fearing that recession pressures pose a greater threat than inflation to the New Zealand economy in the near term, the RBNZ Governor Alan Bollard decided to reduce the OCR rate by 25 basis points to the new rate of 8 percent. This is the first time since 2003 that the RBNZ has reduced the rate. While the majority of local economist were predicting that Bollard would first wait to see the wage/price data in August and then announce the change in September, Bollard said, "more unpleasant international news has emerged since June and there is a risk that the domestic economy will slow further" (see reftel).

He predicted that the annual inflation rate (CPI) would peak at around 5 percent in September then return to a level within the target inflation band (1 to 3 percent) in the medium term. RBNZ expects economic activity to remain weak for the rest of this year and will pick up only gradually next year aided by high export prices, tax cuts and higher government spending. In the meantime, the RBNZ will keep a close eye on pressure on wage/price demands and the rate of decline in the value of the Kiwi dollar in calculating further adjustments to the OCR.

Is the Rate Change a Mandate Change?

12. (SBU) The decision today by the RBNZ signals a move away from its original legislated mandate to set the OCR to restrain inflation between a narrow range of 1 to 3 percent. Bollard has essentially exceeded the Reserve Bank's legal mandate by this decision. The law requires the Bank to focus on one responsibility only: keeping the inflation rate in a band between 1 and 3 percent. Analysts here have bemoaned in recent months that the Bank does not have the flexibility to consider the broader impact of interest rates on the economy and labor market, as the Federal Reserve in the U.S. does. It appears that Bollard has exceeded his mandate, covering his tracks by predicting that inflation will fall later this year despite the Bank reducing the OCR now.

13. Fearing a looming recession the Associate Finance Minister Trevor Mallard signaled earlier this month that the government might be considering a possible break with the Bank's 20 year-old legal mandate by proposing a shift away from interest rates as the sole weapon against inflation. National Party finance spokesman Bill English reiterated that his party continues to back the current framework; saying softening the inflation target would ultimately

lead to even higher interest rates in the long run. In June English said that, if National won the election, it would not rewrite the policy target agreements.

14. Foreign Minister Winston Peters argued earlier this month the RBNZ law might provide some unexpected flexibility in the Bank's mandate by highlighting a section in the Reserve Bank's statement of intent that said the Bank aimed to deepen its understanding of "options for alternative instruments". Mr. Peters said he was encouraged by the Bank's statement, but feared 95,000 jobs would be lost unless RBNZ acted soon. "We advocate a rewrite of the act to enable the governor to take into account the balance of payments, exports, GDP growth and full employment when setting the official cash rate." The Finance and Expenditure committee has been investigating options and is expected to report back to Parliament in September but is considered unlikely to reach a consensus on possible immediate changes. Meanwhile today's decision by the RBNZ may signal a de facto change.

MCCORMICK